VZCZCXRO7557
PP RUEHIK
DE RUEHLO #2478/01 3071552
ZNR UUUUU ZZH
P 031552Z NOV 09
FM AMEMBASSY LONDON
TO RUEHC/SECSTATE WASHDC PRIORITY 3869
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHDC PRIORITY
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY
RUEHBL/AMCONSUL BELFAST PRIORITY 1429
RUEHED/AMCONSUL EDINBURGH PRIORITY 1224

UNCLAS SECTION 01 OF 03 LONDON 002478

SENSITIVE
SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN ETRD EINV UK
SUBJECT: UK GOVERNMENT GETS TOUGH ON BANK BONUSES; DEBATES CURBS ON "CASINO" BANKING

LONDON 00002478 001.3 OF 003

¶1. (SBU) Summary: The UK government is getting tough on compensation for bankers. On January 1, a code of practice for compensation requiring large firms to report in detail their company's policies will come into effect. UK-based U.S. firms joined British banks in signing this code of conduct, but some said they felt coerced to sign. Despite HMG actions to rein in bonuses, the Conservative Party has argued that more needs to be done. UK government officials also are debating whether there should be a return to "narrow banking," with Bank of England Governor Mervyn King advocating a break-up of large banks so that taxpayers do not have to bail-out banks involved in risky trading activities in the future. Chancellor of the Exchequer Alistair Darling has rejected such a proposal. End Summary.

FSA Serious on Bank Bonuses, Enforces Voluntary Code

¶2. (U) In August, the Financial Services Authority (FSA) published a code of practice on bank compensation requiring UK banks and building societies with capital resources exceeding GBP one billion to establish compensation policies consistent with effective risk management and long-term performance. The FSA code defines what constitutes effective pay policy. The 26 largest British banks were given a deadline of November 2 to report to the FSA the total amount and structure of bonuses they plan to give out in 2009. (Their plans will be reported septel as/if made public.) The regulator will also require banks to disclose individual compensation arrangements that fall outside the code and set out plans to bring these aspects into line before next year. The code will officially take effect from January 1, 2010.

¶3. (U) Building on the Financial Stability Board's recommendations to the G-20 in Pittsburgh, the UK code specifically states it is good practice for a significant proportion of any bonus - at least two-thirds - to be deferred over three years. It also says guaranteed multi-year bonuses that are not based on performance during the period under review are likely to be inconsistent with effective risk management. While the code is written as a series of recommendations, non-compliant firms could face enforcement action or be forced to hold additional capital.

¶4. (U) While the European Union has proposed implementation of compensation policies by the end of 2010, the FSA said it is likely the UK and possibly one or two other countries will implement a compensation code at least a year ahead of this. However, the FSA noted that practices can be modified based on what comes out of discussions in the EU and the Basel Committee on Banking Supervision. [Note: A target date for the implementation of an agreement in Basel has not yet been set.]

Political Parties Put Bonuses on Center Stage

¶5. (U) Political leaders have taken tough stances on bonuses. Chancellor Darling specifically criticized bonuses at Goldman Sachs and other firms as excessive, saying no bank would be standing if it had not been for taxpayer-funded bailouts. HM Treasury considered a "windfall tax" on bank profits, though recognized this would not help banks increase capital holdings. Shadow Chancellor Osborne on October 26 called on the FSA and HM Treasury to join together to prevent retail banks and their investment banking arms from paying out significant cash bonuses. He advocated bonuses be paid only in company shares, and he said cash that would have been used to pay bonuses should be added to bank balance sheets and used to increase lending. Osborne, who previously called for handling the bonus issue internationally to avoid putting the UK at a competitive disadvantage, noted that the UK would be acting in concert with the U.S. and its recent bonus policy announcements.

Global Banks - Not Pleased

¶6. (SBU) During an October 14 meeting, Financial Services Minister Lord Myners secured commitments from eight international banks with subsidiaries in the UK (Bank of America Merrill Lynch, Citigroup, Credit Suisse, Goldman Sachs, JP Morgan, Morgan Stanley, Nomura and UBS) to adhere to the FSA code. Newspapers reported that banks had been bullied into signing the agreement, a sentiment that was privately expressed to us as well by several U.S. bankers. Representatives of JP Morgan Chase told us while JPMC has signed on to G-20 and the UK FSA code, the details are what is important. Prior to the meeting with Lord Myners, JPMC and other firms understood from the Financial Services Authority that they were being asked to sign on to changes effective 2010. Only at the meeting with Lord Myners were they told the FSA rules would also apply to all 2009 bonuses. JPMC signed on, believing it did not have another choice. Citigroup and Goldman Sachs officials echoed

this view. However, Citi expected U.S. regulations on pay could be more onerous than UK regulations and commented that U.S. and UK regulators would need to harmonize approaches.

¶7. (SBU) The British Bankers' Association (BBA) has supported the general principle of aligning compensation with risk management, but also cautioned that compensation policies must be harmonized globally so as not to disadvantage UK firms. When the FSA was consulting on the code, other firms pointed out that the cost of rewriting contracts to comply with the code, would disadvantage the UK. Firms also felt the guidelines were too prescriptive. In conversations with us, JPMC and Goldman representatives strongly defended their longstanding compensation policies and said the UK regulations would not mean big changes in how they structure compensation. Both said they have consistently used stock options, deferred bonuses, claw back provisions and other policies to tie performance to long-term growth and risk assessment.

A New Glass-Steagall? Views on Breaking Up "Casino" Banks
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¶8. (U) Public anger over bonuses has sparked debate on how banks can be restructured to ensure taxpayer money is not spent implicitly guaranteeing risky activities. Anger has deepened since many of the most profitable banks have seen profits in their investment banking activities, while credit to household and business consumers remains weak.

¶9. (U) In an October 20 speech, Bank of England Governor Mervyn King called for a "serious review" of how the banking industry is structured and regulated. He said HMG and regulators will need to confront the "too important to fail" question, and he advocated separating the utility functions of banks, namely deposit taking and payment systems, from riskier ventures - dubbed "casino" banking - such as proprietary trading. He said the belief that appropriate regulation could ensure speculative activities do not result in failures is a delusion. "We all have a common interest", he argued, in ensuring continuity of service in the utility aspects of banking but taxpayers should not have to bail-out banks involved in risky

trading activities.

¶10. (U) King's comments were in direct contradiction of HMT's positions. In response to the Governor's speech, Chancellor Darling said the problems facing the banking sector were "more complex" than King suggested and added: "I don't think a Glass-Steagall approach, which might have been right in the 1930s, is right for the 21st century." King's comments were also at odds with the FSA. In his spring report, Lord Turner, Chairman of the FSA, said he did not see a need for a strict, legal separation. He said such a separation would not be practical in today's complex global economy, nor is it clear it would radically reduce banking system risks. Rather, Turner, at the FSA's November 2 conference on financial market regulation stated that devising and enforcing appropriate risk management would be a better approach to protecting the public interest than reverting to a new form of Glass-Steagall legal separation.

¶11. (U) John McFall, Chairman of the House of Commons' Treasury Select Committee, has consistently argued for a re-introduction of Glass-Steagall-type legislation. While the Committee's official July report into the banking crisis did not directly call for a legal separation, it said HMG should not rule out a ban on proprietary trading in retail banks. Several British academics also have advocated "narrow banking" options. Professor John Kay, a prominent British economist, for example, has argued that it was unacceptable that HMG had to provide taxpayer funds to protect depositors in banks where problems were created by risky trading activities. He proposed a division between narrow banks focused solely on retail deposit taking and payment services and all other financial activities (which could then be deregulated). Shadow Chancellor George Osborne has described King's comments as "powerful and persuasive" but stopped short of directly endorsing legal separation.

¶12. (SBU) Introducing legislation to legally separate banks would be a retrograde step, according to an official at the British Bankers' Association. He told us there is no traction behind King's argument. No other country is having a serious debate about the re-introduction of Glass-Steagall-type legislation. Instead, he said, countries are focusing on creating a banking model in which risk is better addressed through capital and liquidity requirements and better planning for resolving insolvent institutions. He said this is what the FSA is currently doing. The UK needs a sensible debate around these issues, he argued, instead of looking at legislation that artificially separates banks. In a press release following Mervyn King's October 20 speech, the BBA's chief executive, Angela Knight, said the UK's current mixed banking model

provides choice. She said big businesses may want big banks that offer a range of products and services while individuals may want something smaller. She argued there is a "clear and unambiguous" requirement for universal banks.

¶13. (SBU) Conclusion: With major banks expected to announce their bonuses in the upcoming weeks, the UK government as well as the opposition parties will continue to seek ways to redress the worst abuses. The debate will spill over into the electoral campaign, as Labour and the Conservatives jockey to capitalize on public anger to promise reforms and an end to business as usual. While separating commercial from investment banking will remain attractive to some as a way to prevent recurrence of many of the worst abuses of the past decade, it is highly unlikely that the UK would go alone on this, as UK authorities are keenly focused on maintaining London's role as a leading global financial center. On bonuses, the UK will want to ensure that its approach remains consistent with that of its EU partners and the U.S.

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